

1  **Tax Saving Opportunities  
With Inventories**

Presented by:

SourceCorp Professional Services

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2  **SourceCorp Professional Services**

- Founded in 1983 as LIFO Systems
- Core market was automotive LIFO services
- Began performing IPIC LIFO services in 1998, primarily for PricewaterhouseCoopers
- Currently work with hundreds of Accounting firms of every size across the country and many top-tier CPA Associations/Networks
- Wholly-owned by SOURCECORP, a \$380M privately held company (Apollo Management, Inc., 2006)

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5  **LIFO is a tool that helps businesses grow...**

- It's a tax deferral of \$640,000 that a pipe manufacturer uses to help fund the expansion of the facility
- It's a tool to help a beverage distributor pay for a technology investment, enabling the client to improve it's competitive position in the market
- It's an extra \$2.4M cash over a three-year period that a specialty manufacturer uses to pay down debt

6  **Who is electing to use LIFO?**

- Door manufacturer: \$65M inventory, \$5M initial LIFO reserve
- Manufacturer of party goods: \$7.5M inventory, \$244K initial LIFO reserve
- Retailer of tires: \$10.7M inventory, \$277K initial LIFO reserve
- Heavy equipment dealer: \$14.4M inventory, \$375K initial LIFO reserve
- Processor of strip copper alloys: \$3.3 inventory, \$751K initial LIFO reserve
- Heavy truck dealer: \$9.5M inventory, \$303K initial LIFO reserve
- Manufacturer of metal pails: \$4.3M inventory, \$707K initial LIFO reserve
- Mechanical pipe and tubing wholesaler: \$44.4M inventory, \$1.2M initial LIFO reserve
- Commercial door hardware wholesaler: \$2.5M inventory, \$160K initial LIFO reserve
- Metal fabricator: \$14.9M inventory, \$2.9M initial LIFO reserve
- Lawn & garden equipment retailer: \$7.2M inventory, \$448K initial LIFO reserve

7  **Who is electing to use LIFO?**

- Brick manufacturer: \$30 M inventory, \$1.1M initial LIFO reserve
- Dried food distributor: \$5.8M inventory, \$325K initial LIFO reserve
- Fine jewelry retailer: \$5.4 M inventory, approx \$235K initial LIFO reserve
- Manufacturer of tubular welding wire: \$10M inventory, \$1.025M initial LIFO reserve
- Wholesaler of poultry products: \$12M inventory, \$1.035M initial LIFO reserve
- Restaurant supply wholesaler: \$12.6M inventory, \$740K initial LIFO reserve
- Energy drink distributor: \$2.7M inventory, \$250K initial LIFO reserve
- Wholesaler of specialty chemicals: \$16M inventory, \$1.4M initial LIFO reserve
- Manufacturer of air and gas compressors: \$6.3M inventory, \$545K initial LIFO reserve

8  **Quiz Question #1**

- What type of taxpayers may elect LIFO?
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- A. Manufacturers
- B. Retailers
- C. Wholesalers
- D. All of the above

E.

9  **What is LIFO?**

- LIFO is an accounting cost flow methodology
- LIFO assumes the goods most recently purchased are the goods first sold. When prices are rising, the LIFO method assumes that the taxpayer retains the earlier purchased, and lower priced goods in inventory
- LIFO taxpayers do not have old inventory on hand
- Think of a grocery store on LIFO. They do not have 1-year, 5-year, or even 20-year old milk in physical inventory; however, from an accounting standpoint they might have milk valued at 1-year, 5-year or even 20-year old prices
- Indefinite income deferral or Interest-free loan from the Government (don't buy a boat!)

10  **LIFO Example**

Facts:

- LIFO is elected for the 12/31/08 tax year
- This means that we will be measuring prices from the beginning of 2008 (1/1/2008)
- The taxpayer in our example has only one inventory item (milk)


11  **LIFO Example**

- At 1/1/2008 the taxpayer has 10 gallons of milk on hand. Each gallon costs \$1.00 so the total value of ending inventory is \$10.00 (10 gallons x \$1.00 per gal.)

12  **LIFO Example**

- At 12/31/08, the taxpayer has 14 gallons on hand. During 2008, the price of a gallon increases from \$1.00 to \$1.40 (40% inflation) so the total inventory value at 12/31/08 is \$19.60 (14 gal x \$1.40/gal)
- If not using LIFO, the taxpayer would report an inventory value of \$19.60
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- If using LIFO, the taxpayer would report an inventory value of \$15.60 (\$4.00 less)

13  **LIFO Example**

How is the difference calculated?

- LIFO looks to see how many items were in prior year inventory and values those items at their prior year cost. Any additional items are valued at their current year cost. See illustration below:
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- LIFO Reserve (Benefit) = \$4.00 (\$19.60 value as reported on the books vs. \$15.60 computed LIFO value)

14  **LIFO Example**

Let's go one year further:

- At 12/31/09, the taxpayer has 20 items and each item is valued at \$1.70 (up from \$1.40, so 21.4% inflation)
- If not using LIFO, the taxpayer would report an inventory value of \$34.00
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- If using LIFO, the taxpayer would report an inventory value of \$25.80 (\$8.20 less)

15  **LIFO Example**

- How is the difference calculated?

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- LIFO Reserve (Benefit) = \$8.20 (\$34.00 value as reported on the books vs. \$25.80 computed LIFO value)
- The LIFO Reserve increased in 2009 by \$4.20 (\$8.20 - \$4.00). This represents the current year benefit or current year additional deduction (P&L impact)

16  **Example Conclusions**

- The process illustrated in the example continues year after year
- This means that LIFO is not a one-time, one-year benefit. It will continue to grow as long as inventory items experience inflation
- The example uses specific items as opposed to dollar value in the calculation
- Because taxpayers always have more than one item (some may have hundreds of thousands) using an item's dollar value instead of the number of items in the LIFO calculation is administratively easier

17  **With and Without LIFO...**

18  **Quiz Question #2**

- What is the key driver in determining LIFO benefit?

- A. Inventory level
- B. Inventory inflation
- C. Inventory turns
- D. Inventory mix
- E.

19  **Basic example...**

20  **Assuming inflation, LIFO reserves grow over time...**

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24  **Assuming inflation, LIFO reserves grow over time...**

25  **Assuming inflation, LIFO reserves grow over time...**

26  **Requirements to use...**

- Form 970 for initial LIFO election, or moving to the IPIC method from an internal index LIFO method.
- Form 3115 to change from one LIFO method (internal index) to a different LIFO method

- (IPIC).
- Conformity requirement
  - Reduces financial statement earnings
  - Could affect year for adopting LIFO
- Inventory must be valued at cost
  - Lower of Cost or Market (LCM) adjustments restored to income over 3 years
- 27  **Restoring LCM Reserves to Cost When electing the LIFO Method**
- 28  **Lower of Cost or Market vs. LIFO**
- 29  **LIFO Methods**
  - IPIC (Inventory Price Index Computation) is an optional method that measures inflation based on Consumer Price Indexes (CPI) or Producer Price Indexes (PPI) published by the Bureau of Labor Statistics (BLS)
  - Other LIFO methods measure inflation based on changes in internal costs (there are as many methods as there are companies using a non IPIC method)
  - Taxpayer can and should consider both methods and weigh many factors before initial election...
- 30  **IPIC LIFO method utilizes published inflation data**
  - Published monthly by BLS
  - Domestic measure of inflation only
  - Approximately 2,600 PPI indexes, 350 CPI indexes
  - Indexes start at a 2-digit level (for industry grouping) and go down to an 8-digit level
  - Must categorize ending inventory to most detailed BLS code (sounds easier than it is)
- 31  **Excerpt from PPI Code listing...**
- 32  **Sample IPIC Categorization...**
- 33  **Quiz Question #3**
  - What are the major advantages of the IPIC LIFO Method?
  - - A. Only IRS approved method
    - B. Audit protection from other LIFO methods
    - C. Possibly better tax benefit vs. other LIFO methodologies
    - D. All of the above
- 34  **Modeling the computations...**
  - Options available under the regulations can be analyzed to maximize the tax benefit
    - CPI vs. PPI
    - Preliminary vs. Final
    - 10% grouping/weighting vs. disregarding these rules
    - Representative Month vs. Appropriate Month
    - Traditional Pooling vs. IPIC Pooling
- 35  **IPIC Sub-method Summary Report**
- 36  **Case study... client changes to IPIC method for better tax benefit**
  - Windshield distributor on LIFO for 12 years
  - Current LIFO method was showing deflation for the year
  - Ran 14 scenarios, two of which were inflationary.
  - Reserve increased by \$500,000 versus recapturing \$200,000 in reserve
  - A difference in income of \$700,000
- 37  **Case study... company changes to IPIC method to simplify computations**
  - A manufacturer of health and nutrition products had been on the LIFO method for 18 years
  - The computations were very difficult and time consuming
  - Both the taxpayer and the CPA were spending great amounts of time to compute LIFO annually
  - They changed to the IPIC method because their main source of pain was in the computations themselves...they wanted to outsource the work

- After running 24 scenarios, analyzing both preliminary and final indexes, the IPIC method provided 12% inflation on their current year inventory, much higher than the amount they had been projecting

38  **Case study... company changes to IPIC method for audit protection**

- A wholesale pool and spa supply distributor had been on LIFO for 7 years
- They were concerned that their LIFO reserve could be in jeopardy if they were chosen for a LIFO audit
- They received audit protection for the previous methodology and LIFO reserve by changing to the IPIC method
- They were thrilled to more than triple their cumulative LIFO reserve in the year of change

39  **Advantages of other LIFO methods**

- Possibly better tax benefit vs. IPIC method
- Can change automatically to the IPIC method when it yields a better tax answer or when audit protection is desired

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Disadvantages of other LIFO methods

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- Item definition issue (must compare identical, not similar)
- When identical items do not exist, taxpayer must sacrifice inflation or be able to argue that a particular reconstruction method properly reflects income

40  **Examples of companies that elected the IPIC method but subsequently changed to a method utilizing internal inflation...**

We don't know of any

41  **Ideal Company Profile For LIFO Consulting...**

- Any company already using LIFO
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- Any company not using LIFO:
  - Carry inventory
  - Profitable
  - Understanding of the conformity requirement
  - Inflation in their industry

42  **The Evaluation Process**

- Inventory summary, or detailed inventory listing for both year beginning and year ending inventory
- Prior-year LIFO work papers for companies already on LIFO
- Other basic inventory information (# inventory turns, etc.)
- Deliverable will be an estimated LIFO reserve summary

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44  **High level (website) estimate deliverable**

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47  **Quiz Question #4**

- How much year-ending inventory does a taxpayer need to elect LIFO?
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- A. \$1 million
- B. \$5 million
- C. It depends on the taxpayer's inflation

48  **Common Concerns...**

- Client turns inventory too often
- Bankers may not understand (financial statement impact)
- What if inflation goes away?


- Can client elect off of the method?
- Why didn't you bring this idea to me sooner?
- Is LIFO an AMT/ACE adjustment
- It's just a deferral...why do it?

49  **International Financial Reporting Standards and LIFO**


- Convergence for largest public companies to possibly begin soon
- IFRS doesn't recognize LIFO
- Footnote to financial statements could solve the issue
- Repeal of the conformity requirement is possible
- Highly unlikely that largest public companies will go off of LIFO without a fight
- President Obama's SEC Chairperson will not be held to the same convergence timetable as her predecessor
- The LIFO Coalition consists of 150 trade organizations focused on protecting LIFO
- Currently no timetable for private company convergence

50  **What Makes Us Different**

- Have partnered with accounting firms and their clients for 25 years
- Company was built to perform complicated LIFO computations accurately and within IRS regulations
- In addition to accuracy, we maximize the tax benefit within regulations for all our services
- Will provide a fixed fee quote for all our services
- Audit support provided
- Unconditional satisfaction guarantee
- We partner with accounting firms to identify and develop client opportunities, and estimate the potential tax benefit at no cost

51  **Value for the Accounting Firm**

- Value to clients means value to the accounting firm
- Build goodwill with clients
- Discuss with clients before a competing firm does
- Possible value billing opportunity
- Winning a new client for both audit and tax

52  **Industries With Inflation Thru 12/08...**

- Agricultural chemicals
- Paving and roofing materials
- Inorganic chemicals
- Plastic materials
- Meat products
- Tires
- Fabricated metal products
- Office furniture
- Paper products
- Drugs
- Plastic products
- Poultry
- Sand and gravel

53  **Industries With Inflation Thru 12/08 continued...**

- Food products
- Plumbing supplies
- Concrete and gypsum products
- Metal forgings and stampings
- Hardware
- Crushed and broken stone
- Beverages


- Household furniture
- Glass
- Plumbing equipment
- Heating equipment
- Metalworking machinery
- Cigars
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54  **Industries With Inflation Thru 12/08 continued...**

- Cutlery
- Hand tools
- Farm & garden machinery and equipment
- Household appliances
- Aircraft
- Home furnishings
- Footwear
- Cigarettes
- Books
- Paperboard containers and boxes
- Paint
- Eggs
- Beer
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55  **Industries With Inflation Thru 12/08 continued...**  
• Many, many more...

56  **Questions?**

57  **For Your Free Initial Analysis:**  
SourceCorpTax.com